Smid Cap Equities: Seeking Middle Ground Along the Risk/Return Spectrum

While small cap stocks represent a particularly volatile and inefficiently priced segment of the capital markets, First Eagle believes these same dynamics can create opportunities for disciplined active investment managers in search of undervalued businesses.

At the same time, we understand that some investors may prefer a less aggressive risk/return profile than what is often found in this segment of the market, especially given the current uncertain environment.

Our Small Cap team believes its time-tested approach to small and microcap stocks also can be applied to midcap businesses, allowing the team to construct "smid cap" portfolios that offer the potential for attractive returns with less volatility than those consisting only of smaller names. For more information, we spoke to our Small Cap team responsible for First Eagle's new Smid Cap strategy: Portfolio Manager Bill Hench, Associate Portfolio Managers Suzanne Franks and Rob Kosowsky, Senior Research Analyst Adam Mielnik, Research Analyst Connor Sheehy and Trader/Analyst Mark Salamone.

KEY TAKEAWAYS

- While volatility in the small cap market historically has presented attractive opportunities for disciplined active managers, some investors may seek strategies with a less aggressive risk/return profile.
- The "smid cap" universe offers the potential for attractive returns with lower volatility given the stabilizing impact of more-liquid midcap stocks alongside smaller names.
- We believe that businesses with competitive advantages—regardless of size—ultimately should trade at a premium to their lower-quality competitors, and we seek to take advantage of opportunities to acquire such companies when they trade at a discount to their normalized valuation.
- With the flexibility to direct capital to what we view as the best opportunities across a very broad investment set, First Eagle's new US Smid Cap strategy seeks to improve upon the already attractive risk/return tradeoff evident in the smid cap space.

Views expressed are as of July 31, 2022.

Q:

Why have you introduced a smid cap strategy?

Small and microcap stocks historically have been a particularly volatile and inefficiently priced segment of the US equity market, and this elevated volatility has helped drive outperformance relative to large caps over the past several decades.[1] Because of their relative illiquidity, however, smaller cap stocks have tended to be subject to dramatic price swings during periods of heightened volatility, as has been evident in 2022. Whipsawed by geopolitical conflict, persistently high inflation, a hawkish Federal Reserve, and, more recently, burgeoning recession fears, the Russell 2000 Index has fallen 15.4% year to date compared to a 12.6% decline in the S&P 500 Index.[2] Similarly, the CBOE Russell 2000 Volatility Index's average reading for the seven-month period stood at about 32, while the S&P 500-based CBOE Volatility Index "VIX" was closer to 26.[3]

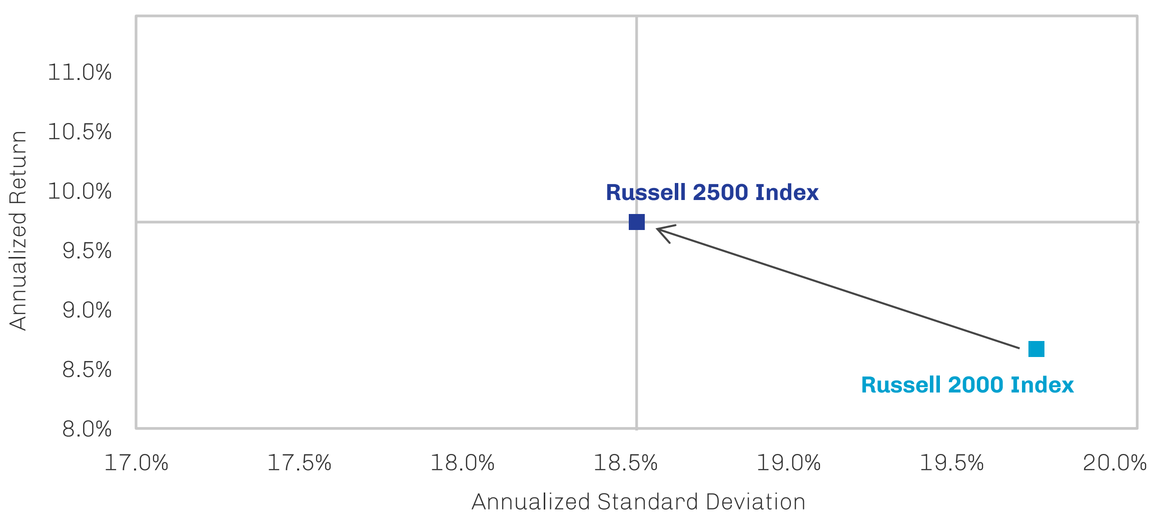
While we believe such price volatility can create compelling opportunities for disciplined active managers, we also understand that some investors might prefer a different risk profile in the current uncertain environment. In our US Small Cap strategy, we seek to mitigate risk primarily through stock selection and broad diversification. However, another way we attempt to manage portfolio risk is through broadening the opportunity set to include less-volatile midcap stocks alongside small and microcap names; that is to say, through a smid cap approach.

Looking at index-level performance over the last 20 years, smid cap stocks (as represented by the Russell 2500 Index) delivered higher returns than the small cap index with less risk, as shown in Exhibit 1.[4] We take a more expansive view of the opportunity set than the Russell 2500, and our smid cap universe includes about 4,000 stocks—500 midcap names in addition to the 3,500 or so small and microcap stocks we already cover as part of our US Small Cap strategy. With the flexibility to direct capital to what we view as the best opportunities across a very broad investment set, our new US Smid Cap strategy seeks to improve upon the already attractive risk/return tradeoff evident in the traditional smid cap space.

> Our US Smid Cap strategy allows us the flexibility to direct capital to what we view as the best opportunities across a very broad investment set.

Exhibit 1: Smid Caps Historically Have Offered an Enhanced Risk/Return Profile

July 1, 2002, through July 31, 2022



Note: The Russell 2500 Index is a proxy for US smid cap stocks, while the Russell 2000 Index represents small cap stocks.
Source: FactSet; data as of July 31, 2022.

1,2,4. Source: FactSet, data as of July 31, 2022.
3. Source: Chicago Board Options Exchange, Federal Reserve Bank of St. Louis; data as of July 31, 2022.

Past performance is no guarantee of future returns.

Q:

What are some features of a smid cap strategy?

We believe midcap stocks, generally speaking, are subject to many of the same dynamics that cause pricing inefficiencies in the small and microcap space—if to a lesser degree—and these inefficiencies periodically create opportunities to invest in companies at prices we believe represent a discount to their normalized values. Midcap stocks historically have demonstrated less volatility than smaller names, however, and leveraging an opportunity set comprising both midcap and small/microcap stocks enables us to construct smid cap portfolios with risk/return profiles that some investors may find more appealing.

Common business risks—revenue and earnings stability, management skill and balance sheet strength, to name just a few—tend to exist on a size-based continuum, accompanied by a corresponding scaling of market volatility. A large cap company may have a broadly diversified product line, a deep bench of talent and easy access to the capital markets, factors that all help promote operational stability and a certain degree of resilience. In contrast, a smaller company may have a narrow line of products, limited organizational depth and a high cost of capital, giving it a narrow margin for error. As could be surmised, mid-sized companies tend to fall toward the middle of this spectrum.

Wall Street coverage tends to demonstrate a similar pattern, which we believe is a key reason why the market price of individual companies can at times become widely disconnected from their normalized values. Apple (the largest company in the S&P 500) is followed by 43 analysts, compared to 19 for Quanta Services (the largest in the Russell 2500) and eight for Biohaven Pharmaceutical (the largest in the Russell 2000).[5] With fewer professionals dissecting the merits and flaws of smaller companies, the resulting increase in information asymmetry promotes greater market price inefficiency.

As investment managers, we see two features to a smid cap mandate. The first is opportunity. Not only do we have 500 additional mid-sized companies eligible for investment consideration, we are able to maintain exposure to smaller businesses that outgrow the small cap space—assuming our investment thesis remains intact and their price remains compelling. On a market capitalization basis, nearly 60% of the Russell 2500 falls in the midcap space, suggesting the option of a longer holding period for successful investments and potentially a greater return on investment.

The second feature is flexibility. While broad diversification is a key contributor to risk management in the US Small Cap strategy, the lower volatility of midcap stocks allows us to manage risk effectively with fewer holdings and, thus, to be more selective across the US Smid Cap strategy. The US Smid Cap portfolios hold 70–100 names instead of the 180–300 positions we maintain in US Small Cap, with correspondingly larger position size targets. We believe our best ideas can make an impact over the long term.

> The smid cap mandate allows us to maintain exposure to investments that may potentially outgrow the small cap space.

And while we're stock pickers at heart, we're not blind to the state of the world and we need to consider the potential impact of systemic risks on the companies in the smid cap space. Whether it's multidecade-high inflation, receding fiscal and monetary support, a war in Europe, geopolitical unrest and a pandemic with an uncertain trajectory, these are all huge concerns that seem highly unlikely to be resolved in the very near future.

Q:

How does the investment process for the US Smid Cap strategy differ from that of the US Small Cap strategy?

In short, it doesn't. Though larger and more mature, midcap stocks are subject to many of the same forces that drive pricing inefficiencies in smaller names. As a result, we are able to apply our disciplined, time-tested approach to the small and microcap universe to uncover midcap stocks that have become disconnected from their normalized values.

We believe that businesses with competitive advantages—regardless of size—ultimately should trade at a premium to their lower-quality competitors. At the same time, price disconnects can occasionally impact even what we consider the best companies. A company may simply be inefficiently valued by the market, typically due to an underestimation of its sum-of-the-parts value. Others represent classic turnaround scenarios in

5. Source: *Barron's*; data as of June 30, 2022.

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which some adverse event like a demand disruption or management failure depresses a stock's price until a solution can be implemented. Finally, we have companies whose qualities—be it accelerating growth potential, the efficiency of their operations or an advantaged industry position—are underappreciated by the market. It's also worth noting that businesses of all sizes are subject to the ups and downs of business cycles; the broad market decline in 2022 has brought a number of potential investment targets into our sights that may have been too large at the start of the year.

Once we identify a stock we believe to be mispriced, we seek to understand why this discount exists and, importantly, if it is fixable. If we believe the current discount is due to some transitory issue, we look for a specific catalyst on the horizon that may serve to normalize the stock's market valuation. Catalysts can include new management, a more favorable business cycle, product innovation and margin improvement, and they are key to avoiding "value traps" in which low-priced stocks are cheap for a reason.

Our sell discipline, too, remains consistent across these two mandates. We exit positions when they reach our estimate of normalized valuation and often take advantage of positive price momentum to reduce position size. The biggest distinction between the two strategies will be the ability to maintain exposure to stocks appreciating in value beyond the small cap ceiling when we believe there is still incremental return potential.

Q:

Does the expansion of the opportunity set impact the team's ability to stay on top of what is already a very large coverage universe?

While our opportunity set is large, our catalyst-driven approach frees us from considering every single detail of every company's business. We listen to 1,000-plus earnings calls each year, but our attention is focused on determining the progress each company is making toward the specific impediments to price normalization.

For new investment ideas, we're always on the lookout for opportunities that deserve further research. All members of the Small Cap team are analysts, and we're all generalists. We all pitch potential investments from a range of sectors and industries, and alternate quarterly earnings review of each portfolio holding over time, creating a broader pool of opinions and less personal attachment to individual stocks. We read a range of market, macro and industry-specific content. We attend conferences, engage management teams directly and keep tabs on companies we've owned in the past for potential opportunities in the future.

Further, we expect to benefit from the significant overlap between the midcap and small/microcap universes and the institutional knowledge we have developed in the space over time. Our many years spent covering small and microcap stocks has provided us with a natural familiarity with names across the smid cap spectrum, many of which we closely followed or even owned when they were smaller. There are some particular industries, such as optical equipment and semiconductor capital equipment, that have experienced notable consolidation in recent years, resulting in a number of stocks that became too large for the US Small Cap strategy but potentially may be appropriate for US Smid Cap.

> We have added resources to the Small Cap team over the past year, with an eye toward both deep experience and fresh perspectives.

Acknowledging the incremental demands of the new strategy as well as the strong cash flows we have seen from investors in the US Small Cap strategy, we have added resources to the team since becoming part of First Eagle in April 2021, with an eye toward both deep experience and fresh perspectives. Mark Salamone, who has more than 20 years of investment management experience, joined the Small Cap team as a trader late last year from Royce Investment Partners. Just last month, Connor Sheehy came on board as a research analyst after earning a BS in business from the NYU Stern School of Business. We also have an open search for another analyst.

Q:

What is your approach to attempting to manage portfolio risk in the US Smid Cap strategy?

Midcap stocks tend to have more trading volume, better liquidity and less volatility than small and microcap names, which historically has limited some of the bigger price swings that we see in the latter space. A key consequence of midcap access is that we can attempt to manage portfolio risk effectively with fewer holdings and, thus, be more selective across the US Smid Cap strategy. The US Smid Cap strategy targets 70–100 names instead of the 180–300 positions we maintain in US Small Cap.

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Position sizes will increase correspondingly, enabling what we consider to be our best investment ideas to make a greater impact over the long term.

While the enhanced liquidity of the smid cap target universe eases some of the complications involved with trading smaller stocks whose prices may be impacted by large orders, we remain focused on putting capital to work incrementally as needed to get the best average price we can. As with the US Small Cap strategy, we establish stock positions in the US Smid Cap strategies at a level we find attractive and slowly add to it at a pace that can be easily absorbed by the market. Our sell discipline is the same, but in reverse.

Of course, the enhanced liquidity of the US Smid Cap strategy's opportunity set does not exempt us from perhaps the most critical rule for seeking to manage portfolio risk: Keep the portfolio cheap. We remain focused on maintaining a portfolio with a lower valuation than the Russell 2500 based on price to book and/or price to sales. The price-to-earnings ratio tends to be less germane given our focus on companies whose earnings we believe to be temporarily impaired.

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Risk Disclosures

The Strategy is new and may not be successful under all future market conditions. The Strategy may not attract sufficient assets to achieve investment, trading or other efficiencies.

The value and liquidity of portfolio holdings may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the United States or abroad. During periods of market volatility, the value of individual securities and other investments at times may decline significantly and rapidly. The securities of small and medium sized companies can be more volatile in price than those of larger companies and may be more difficult or expensive to trade.

There are risks associated with investing in foreign investments (including depositary receipts). Foreign investments are susceptible to less politically, economically and socially stable environments, and adverse changes to government regulations.

A principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value. "Value" investments, as a category, or entire industries or sectors associated with such investments, may lose favor with investors as compared to those that are more "growth" oriented.

All investments involve the risk of loss of principal.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Standard deviation is a statistical measure of the distance a quantity is likely to be from its average value. It is applied to the annual rate of return to measure volatility.

One cannot invest directly in an index. Indices do not incur management fees or other operating expenses.

S&P 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy and is not available for purchase. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 80% coverage of US equities it is also considered a proxy for the total market.

Russell 2000 Index is an unmanaged index that measures the performance of the 2000 smallest companies in the Russell 3000 Index and is not available for purchase.

Russell 2500 Index measures the performance of the small to midcap segment of the US equity universe, commonly referred to as "smid" cap. The Russell 2500 Index is a subset of the Russell 3000® Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2500 Index is constructed to provide a comprehensive and unbiased barometer for the small to mid-cap segment. The index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small to mid-cap opportunity set.

CBOE Volatility Index (VIX) is a measure of the 30-day expected volatility of the US stock market. It is based on the prices of options on the S&P 500 Index and is calculated by aggregated weighted prices of the index's call and put options over a wide range of strike prices.

CBOE Russell 2000 Volatility Index (RVX) is a VIX-style estimate of the expected 30-day volatility of Russell 2000 Index returns. RVX is calculated by interpolating between two weighted sums of option mid-quote values, in this case options on the Russell 2000 Index. The two sums essentially represent the expected variance of the Russell 2000 Index returns up to two option expiration dates that bracket a 30-day period of time. RVX is obtained by annualizing the interpolated value, taking its square root and expressing the result in percentage points.

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